Partnership Allocations in Tax Law - A Comparative Study

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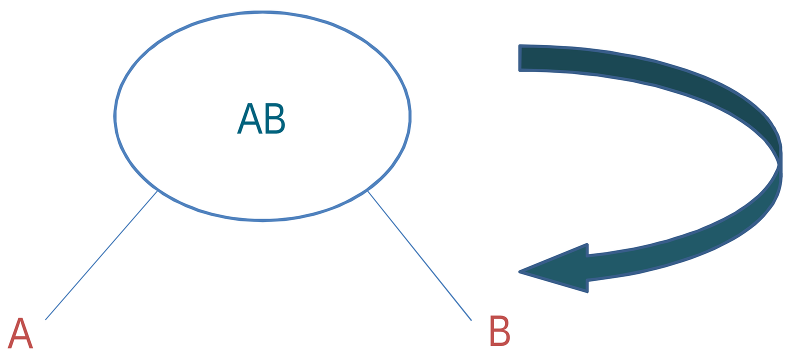
Status quo in Germany:

Calculating taxable income at the level of the partnership



Taxation of gains or utilisation of losses at the level of the partners

How to allocate gains or losses to the partners?

- § 15 para 1 s. 1 no. 2 of the German Income Tax Act refers to the partner's economic interest in partnership profits and losses.
- Private Law grants the partners great flexibility (disproportionate sharing, differing ratio for individual operations, departments or branches, retroactive allocations).
- The courts limit the partners' flexibility for tax law purposes to fight tax avoidance.

This doctoral thesis aims at proposing an alternative way of how to allocate gains or losses of the partnership to its partners.

Selected Problems of Partnership Allocations

Comparative Analysis of Germany and the USA

I. Unrelated Partners

Germany
(case law)

- There has to be a nexus between a partner's distributive share and his contribution to the partnership.
- The economic tension between the partners indicates that the allocation agreement is based on economic aspects only.
- Problem: Disproportionate allocations leading to tax savings

USA
(§ 704 (b) IRC)

- In principle, the distributive share must conform to the partner's interest in the partnership ("facts and circumstances test": relative contributions to the partnership, interests in the economic profits and losses, interests in cash flow, sharing of liquidation proceeds etc.).
- Disproportionate allocations leading to tax savings are accepted, if they have a substantial economic effect.

Research Questions:

- Is a nexus between the distributive share and the partner's contribution necessary?
- To what extent should allocations among unrelated partners which lead to tax savings be accepted?

II. Related Partners

Germany

Family partnerships* | **Economically related partners**

The allocation of gains and losses must be reasonable (arm's length principle).

* Partnership interest of a family member is created by gift and no services are rendered by this family member: only a fair return on the interest's value is accepted (15 percent).

USA

Gifted partnership interest

- Reasonable compensation for services rendered by the donor
- Allocation of residual income in relation to capital interests

Economically related partners

- No special regulation in the IRC
- § 482 IRC might be applied for re-allocation purposes (arm's length principle).

Research Question:

Is a special approach to related partners necessary?

III. Retroactive Allocations

Germany

- Case law: Income is assigned to the partners at the time the business transaction generating the income is carried out
- Varying partnership interests during the tax year must be taken into account.
- Retroactive amendments to an allocation agreement during or at the end of the tax year are not accepted.

USA

- § 706 (d) IRC: Varying partnership interests during the tax year must be taken into account.
- Reallocations among contemporaneous partners before the due date of the partnership return for the period are accepted as long as the adjustments are not attributable to capital contributions or distributions.

Research Questions:

- Who carries out the business transactions – the partners or the partnership?
- Should reallocations based on economic reasons be accepted?